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STATE FOR EB/ESC/TFS; INL; EUR/SCE/DSCHROEDER
TREASURY FOR FINCEN AND U/S TIMOTHY ADAMS
DOJ FOR OIA AND AFMLS AND CARL ALEXANDRE

SIPDIS

E.O. 12958: N/A

TAGS: [EFIN](#) [KCRM](#) [KTFN](#) [PTER](#) [SNAR](#) [SR](#) [MW](#)

SUBJECT: SERBIA: 2006-2007 INCNR SUBMISSION PART II -
FINANCIAL CRIMES AND MONEY LAUNDERING

REF: STATE 157000

INTRODUCTION

¶1. As the result of a public referendum on May 21, 2006, the State Union of Serbia and Montenegro (SAM) was dissolved and Montenegro became an independent country. The Government of the Republic of Serbia (GOS) became the legacy member of the Council of Europe and the United Nations. As a result, all treaties and agreements signed by the State Union are now applicable to Serbia. Separate reports will be submitted for the Republic of Serbia, Kosovo and the Republic of Montenegro.

¶2. The Serbian parliament adopted a new constitution on November 8, 2006, and passed a Constitution Law for its implementation after a new Parliament is elected on January 21, 2007. It is unclear at this time whether the implementation of the new constitution will impact existing and pending legislation in regards to Serbia's anti-money laundering/counter-terrorist financing (AML/CFT) regime.

¶3. At the crossroads of Europe and on the major trade corridor known as the "Balkan route," Serbia still confronts narcotics trafficking, smuggling of persons, drugs, weapons and pirated goods, money laundering, and other criminal activities. Serbia is not a regional financial center, nor is it a money-laundering center. Serbia is located in Southeastern Europe (the Balkans), bordering Macedonia and Kosovo to the south, Romania and Bulgaria to the east, and Croatia and Montenegro to the west, and Hungary to the north. Major highways carry European-bound traffic through Croatia and Hungary. Within the Republic of Serbia is the nominally autonomous province of Vojvodina. Kosovo, recognized by the UN as part of Serbia, has been administered by the United Nations Mission in Kosovo since 1999. (Since Serbia no longer exercises effective control over Kosovo, this report does not address Kosovo.) Serbia has a population of approximately 8 million.

¶4. A significant volume of money flows to Cyprus, reportedly as the payment for goods and services. The records maintained by various government entities vary significantly on the volume and value of imports from this small island nation. According to official statistics from the National Bank of Serbia, over USD 1 billion in payments in 2005, coded as being for goods and services, rank Cyprus among the top five exporters of goods or services to Serbia. The Serbian Statistical Office reflected imports from Cyprus of roughly USD40 million in 2005. According to

GOS officials, much of the difference is due to payments made to accounts in Cyprus for goods actually originating from a third jurisdiction, e.g., Russian oil.

¶15. Serbia continues to be a significant black market for smuggled goods. Illegal proceeds are generated from predicate, or antecedent, crimes such as drug trafficking, official corruption, tax evasion, organized crime and other types of crimes. Proceeds from illegal activities are being heavily invested in all forms of real estate. The construction and renovation of commercial buildings such as offices, apartments, high-end retail businesses as well as personal residences is evident in the capital of Belgrade as well as other major cities. Trade-based money laundering, in the form of over- and under-invoicing, are common methods used to launder money.

¶16. Serbia has 14 designated free trade zones, three of which are in operation. The free zones were established to provide customs duties benefits to companies operating out of these zones and therefore attract investment. These companies are subject to the same supervision as other businesses in the country. There is no evidence of trade-based money laundering schemes or terrorist financing in these zones.

¶17. Serbia introduced a VAT tax in 2005, and the full impact of refund fraud associated with the administration of the VAT is still not clear. Serbia's Tax Administration lacks the audit and investigative capacity or resources to adequately investigate the large number of suspicious transactions that are forwarded by Serbia's Financial Intelligence Unit (FIU). In addition, current tax law sets a low threshold for auditing purposes and has increased the burden on the Tax Administration. This creates a situation

where criminals can spend and invest criminal proceeds freely with little fear of challenge by the tax authorities or other law enforcement agencies.

¶18. The difficulty of convicting a suspect of money laundering without a conviction for the original criminal act and the unwillingness of the courts to accept circumstantial evidence to support money laundering or tax evasion charges is hampering law enforcement and prosecutors in following the movement and investment of illegal proceeds and effectively using the anti-money laundering laws. The GOS has not identified any activities relating to the financing of terrorism. Terrorist financing was criminalized in September 2005, but the law that fully addresses the UNSCR standards and that gives the FIU the necessary power to require the reporting of terrorism financing-related suspicious transactions is still pending.

¶19. Serbia's banking sector is over 80 percent foreign owned. There are no offshore financial institutions, and there is no evidence of any alternative remittance systems operating in the country. There is no provision in the banking law that allows the establishment of offshore banks, shell companies or trusts. There is also no evidence of financial institutions engaging in currency transactions involving international narcotics trafficking proceeds. Banking laws allow financial institutions to disclose client and ownership information to law enforcement authorities in the course of investigations.

LEGISLATIVE FRAMEWORK

¶10. In September 2005, Serbia codified an expanded definition of money laundering in the Penal Code. This gives police and prosecutors more flexibility to pursue money laundering charges since the money laundering conduct is broader under the new law and in conformity with international standards. The penalty for money laundering is up to 10 years imprisonment. This is significant in that under Serbian law and procedure, it falls into the serious crime category and permits the use of Mutual Legal Assistance (MLAT) procedures to obtain information from

abroad. With the penalties previously applicable for money laundering, it did not fall into the serious crime category, and use of the MLAT or letters rogatory were not an option in cases where a serious crime could not be identified as the source of the suspected illegal proceeds.

¶11. On November 28, 2005, Serbia adopted a revised anti-money laundering law (revised AML Law), replacing the July 2002 Law on the Prevention of Money Laundering. The revised AML Law expands the number of entities required to collect certain information on all cash transactions over EUR 15,000, or the dinar equivalent, and to file currency transaction reports (CTRs) for all such transactions exceeding this threshold to the FIU. Suspicious transactions in any amount must be reported to the FIU. The law expands those entities subject to reporting and record keeping requirements, adding attorneys, auditors, tax advisors and accountants to the banks, currency exchanges, insurance companies, casinos, securities brokers, dealers in high value goods and travel agents already required to comply with the AML provisions; required records must be maintained for five years. These entities are protected with respect to their cooperation with law enforcement entities. Other significant changes include the authority of the FIU to freeze transactions for up to 72 hours and to require covered entities and individuals to monitor customers' accounts where money laundering is suspected. The revised AML Law also eliminates a previous provision limiting prosecution to crimes committed within Serbian territory. Significant improvement has been noted in financial institution compliance, i.e., gathering and keeping records on customers and transactions. The flow of information to the FIU has been steadily increasing, but not all entities are yet subject to implementing bylaws.

¶12. The Law on Foreign Exchange Operations, adopted in 2006, criminalizes the use of false or inflated invoices or documents to effect the transfer of funds out of the country. This law was enacted in part to counter the perceived problem of import-export fraud and money laundering. According to the law, residents and nonresidents are obliged to declare to Customs authorities all foreign currency or dinars or securities in amounts exceeding EUR 5,000 that will be transported across the border.

ENFORCEMENT AND SUPERVISION CAPACITIES

¶13. The National Bank of Serbia (NBS) has supervisory authority over banks, currency exchanges, insurance and leasing companies. The NBS has issued regulations requiring banks to have compliance and know-your-customer (KYC) programs in place and to identify the beneficial owners of new accounts. Similar regulations are in process for insurance companies. The Law on Banks includes a provision allowing the NBS to revoke a bank's license for activities related to, among other things, money laundering and terrorist financing. To date, the NBS has not used this revocation authority. The legal framework is in place, but the NBS currently lacks the expertise needed for effective bank supervision. It is building these capacities through training and staff development.

¶14. The Securities Commission (SC) supervises broker-dealers and investment funds. The Law on Investment Funds and the Law on Securities and Other Financial Instruments Market provide the SC with the authority to "examine" the source of investment capital during licensing procedures. The SC is also charged with monitoring its obligors' compliance with the AML Laws. Regulations to implement this authority are in process.

¶15. The 2001 AML law created Serbia's FIU, the Administration for the Prevention of Money Laundering (APML). The revised AML Law elevates the status of the FIU to that of an administrative body under the Ministry of Finance from its previous status as a "sector" in that

Ministry. This provides more autonomy for the agency to carry out its mandate, as well as additional resources. One important change is that the APML now has its own line item operating budget. The APML currently has 24 employees. In accordance with the revised AML Law, the APML developed listings of suspicious activity red flags for banks, currency exchange offices, insurance companies, securities brokers and leasing companies. The APML has signed memoranda of understanding (MOU) on the exchange of information with the NBS and Customs and is negotiating one with the Tax Administration.

¶16. The FIU received 279 suspicious transaction reports (STRs) in 2005 and 361 through September 1, 2006. Virtually all of the STRs received by the FIU have been filed by commercial banks. Currency exchange offices have filed only seven STRs since 2003, and none in either 2005 or 2006. Since its inception in 2003, the APML has opened 240 cases, 74 based on the STRs it received and 166 based on CTRs (see para 9), or referrals from other entities; 103 cases were referred to either law enforcement or the prosecutor's office for further investigation. Since 2004, authorities filed 41 criminal charges against 48 persons for money laundering violations. The most common predicate crime is "abuse of office". Of this number, 18 are currently under investigation, six were dismissed or terminated; 14 were indicted; and two court decisions have been reached so far. One person was acquitted and the other was convicted in the first instance, with an appeal in process. The case on appeal involves just over \$52,000.

¶17. A new Anti-Money Laundering Section was established within the Suppression of Organized Crime Service (SOCS) of the Ministry of Interior to better focus financial investigations.

COUNTERING TERRORISM FINANCING

¶18. In August 2005, the GOS established the Permanent Coordinating Group (PCG), an interagency working group originally tasked with developing an implementation plan for the recommendations from MONEYVAL's first-round evaluation in October 2003. A subgroup was tasked with drafting a new law to address the procedures needed to comply with UN Security Council resolutions regarding the freezing, seizing and confiscation of suspected terrorist assets, and to require reporting to the FIU of transactions suspected to be terrorist financing. Rather than having standing meetings, the PCG appears to meet only intermittently as required for specific tasks. The government still needs better interagency coordination to improve information sharing, record keeping and statistics, and thereby introduce a more effective regime and permit a meaningful assessment of its AML/CFT efforts at all levels of government.

¶19. In September 2005 Serbia criminalized the financing of terrorism through the adoption of the new Penal Code. Under Serbian law, assets derived from criminal activity or suspected of involvement in the financing of terrorism can be confiscated upon conviction for an offense. The APML is the authority charged with enforcing the UNSCR 1267 provisions regarding suspected terrorist lists. A draft law on terrorist financing, now pending Parliamentary approval, will apply the provisions of the AML laws to terrorist financing and will put in place a freezing mechanism based on UNSCR provisions. Although the APML routinely provides the UN list of suspected terrorist organizations to the banking community, checks for suspect accounts have revealed no evidence of terrorist financing within the banking system and no evidence of the usage of alternative remittance systems. The Department for the Suppression of Organized Crime Service (SOCS), the Special Anti-Terrorist Unit (SAJ) and Gendarmerie, in the Ministry of Interior, are the law enforcement bodies responsible for planning and conducting the most complex anti-terrorism operations. SOCS cooperates and shares information with its

counterpart agencies in all of the countries bordering Serbia. Serbia has criminalized the financing of terrorism, but the freezing, seizing and confiscation of assets of terrorists in accordance with UN Security Council resolutions still lacks a legal basis, pending enactment of the Anti-terrorism Finance law.

INTERNATIONAL COOPERATION

¶20. Because of its successor status after the dissolution of the state union with Montenegro, the GOS is a party to the 1988 UN Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances and the UN Convention against Transnational Organized Crime. On October 9, 2003, the former state union ratified the Council of Europe's Convention on Laundering, Search, Seizure, and Confiscation of the Proceeds from Crime. The GOS is a party to 11 of the 12 UN Conventions or Protocols dealing with terrorism, including the UN International Convention for the Suppression of the Financing of Terrorism, although domestic implementation procedures do not provide the framework for full application. As mentioned above, Serbia has criminalized the financing of terrorism, but the freezing, seizing and confiscation of assets of terrorists in accordance with UN Security Council resolutions still lacks a legal basis, pending the enactment of the draft Anti-terrorism Finance law. The GOS also has ratified the UN Convention against Corruption. As a member of the Council of Europe, the GOS is a full and active member of the Council's MONEYVAL Committee. In July 2003, the APML became a member of the Egmont Group and actively participates in information exchanges with counterpart FIUs.

¶21. Serbia has no laws governing its cooperation with other governments related to narcotics, terrorism, or terrorist financing. Cooperation is instead based on participation in Interpol, bilateral cooperation agreements, and agreements concerning international legal assistance. There are no laws at all governing the sharing of confiscated assets with other countries, nor is any legislation under consideration; the GOS may at this time enter into bilateral agreements for this purpose.

¶22. Serbia does not have a mutual legal assistance arrangement with the United States, but information exchange via a letter rogatory is standard. The GOS has bilateral agreements on mutual legal assistance with 31 countries. These agreements authorize extradition of suspected terrorists. The 1902 extradition treaty between the Kingdom of Serbia and the United States remains in force. The GOS generally cooperates with its counterparts and neighbors, and it has responded to U.S. Department of Treasury FINCEN requests for information in a timely manner. In April 2003, the former SAM joined eight other participants in the South Eastern Europe Cooperation Process, in adopting a joint "Belgrade Declaration" to call for the continuation of regional cooperation and the intensification of the fight against terrorism and organized crime. The Serbian FIU has signed information sharing memorandums of understanding (MOUs) with Macedonia, Romania, Belgium, Slovenia, Montenegro, Albania, Georgia,

Ukraine, Bulgaria, Croatia, and Bosnia and Hercegovina.

Pending Agenda

¶23. Among the pending legal infrastructure necessary for Serbia to be fully compliant with international standards are:

- legislation providing for the liability of legal persons for money laundering and terrorist financing;
- regulations to apply all requirements of the Revised AML Law to covered non-bank financial institutions;
- legislation to establish a robust asset seizure and forfeiture regime;
- a pending law to put in place the procedures needed to

comply with UN Security Council resolutions regarding the freezing, seizing and confiscation of suspected terrorist assets and to require suspicions of terrorist financing to be reported to the FIU.

¶24. On an operational level, necessary improvements include: Rather than address only specific tasks, the PCG should meet on a regular basis to discuss issues and projects to enhance the GOS' AML/CTF regime. The PCG should work to improve interagency coordination to improve information sharing, record keeping and statistics. And the GOS should ensure that sufficient resources are available for its law enforcement agencies to work effectively and efficiently.

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